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Tax Reform 1986: A New Ball Game for the Securities Industry & Its Customers

A Summary of Presentations at SIA's Conference on Tax Reform

The 1986 Tax Bill represents a dramatic restructuring of the tax code that will affect every investor, investment product and securities firm. SIA's Conference reviewed the new rules in general, specific product and market challenges, and retail customer opportunities. In addition, the technical and compliance impacts of the bill on the securities industry were discussed as well as the ramifications for New York State and City taxation. This Trends issue summarizes and highlights presentations on these issues.

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THE NEW RULES...AN OVERVIEW

Washington Perspective

Stephan K. Small
Securities Industry Association

The history of the 1986 tax bill is a strange one. Despite the fact that almost every taxpayer believes his taxes are too high and the tax code incomprehensible, the tax bill did not result from a popular ground swell of support. Nor was it the result of pressure from special interest groups. Neither the business community nor labor had much to say on the tax bill initially. As for the Congress, they seemed more eager to get rid of the problem of tax reform than to enact actual tax legislation.

Tax reform began with an odd ideological marriage between a conservative and liberal goal. The conservatives wanted to build on the 1981 tax cuts and the liberals wanted to close loopholes. But the real political start was a ploy -- not to push tax reform but to duck the issue of taxes in the 1984 elections.

For a variety of reasons, the 1981 tax cuts did not increase savings as projected and, in part, contributed to the disappointing increase in the deficit. The President's political advisers felt a discussion of taxes during the election campaign would be a strong negative. Thus, in a brilliant ploy, the President announced that Treasury would do a comprehensive review of the entire tax code, with recommendations to be announced after the elections. The Democrats, not wanting to talk about taxes in 1984 either, also endorsed the concept of tax reform.

We wound up with Treasury I, which immediately drew bad reviews but which the final tax bill mirrors. As to the politics, very few politicians embraced the concept enthusiastically. However, no one wanted tax reform to die on their doorstep. As much to avoid the downside and more so than to advocate the bill, the Ways & Means Committee passed the legislation. In the Senate Finance Committee, the bill fell apart but came together again.

This will not be the last tax bill. There will be another one depending on what happens to the economy. If we have problems, then the chance of restoring some targeted savings and investment incentives would be improved. If everything goes along well, the chance of restoring specific incentives will not be as good. There is, however, great skepticism. The next couple of years will be very challenging. By the next Congress, the securities industry hopefully will develop a consensus on how to restore incentives for savings and investment.

Economic & Market Effects

Allen Sinai
Shearson Lehman Brothers Inc.

The tax bill, with its tremendous change to the tax system, will have a lot of unknown effects in the next few years. Based on the criteria of equity, efficiency and simplicity, the new tax system is fairer than the old. For the household sector, the affluent, particularly those who most use loopholes, are taxed more, while the poor are taxed less. The same holds true for big versus small businesses. Certainly, the bill is a flatter tax. In terms of efficiency, the bill removes loopholes and subsidies. No doubt the economic system will be more efficient in this sense, but the question is what kind of gains from this efficiency will accrue in the macroeconomic sense. Just by virtue alone of removing 6 million people from the tax rolls, the system is more simple.

The fourth criteria for judging a tax system -- macroeconomic impact -- is the biggest unknown. The tax bill is revenue neutral on paper, with a $121.5 billion tax cut for individuals and a $120.5 billion tax increase for business. If the tax bill is, in fact, revenue neutral and that can involve errors of $10-$20 billion, then it will be essentially growth neutral. On average, the economy will not grow much faster nor slower than it would have under the old tax system. Moreover, the bill will probably be inflation neutral.

The main economic impact of the tax bill is compositional. The pattern of growth will be affected year-by-year, not on average over the next five years. The compositional effects of the bill will be felt via a new reverse trickle down theory. Money is taken from business and given to consumers. Households will have much more discretionary income. Our calculations show that over the next five years, 80% of the tax cuts for individuals will be spent and 20% will be saved. In this type of economy, that 80%, about $95-$96 billion, is a lot of consumer spending over five years.

The monies will flow back to the business sector. Some will also leak abroad. The pattern of consumer spending we see suggests that a lot of monies will be spent on non-durable goods and services, not so much on big ticket items or in areas related to the big capital-intensive business from which most of the funds were taken. The $25 billion in savings will be used to pay off debt or to invest. For the financial services industry, there will be a very large increase in the volume of funds to compete for.

Thus, the flow of monies in the reverse trickle down theory moves from business to consumers and back to business. With lags, the trickle down works and business becomes vibrant

again. However, that is a question mark, especially since so much money leaks abroad.

Economywise, the bill raises $11 1/2 billion in 1986 through retroactive elimination of the investment tax credit. Next year, there is a $10 billion decrease in taxes for individuals and a $20 billion increase for corporations. Hence, the bill would tend to restrict economic growth in 1987. In addition, it is an added recession risk for the economy next year, particularly in the first half because the restraining effect will hit an already troubled business sector. As for consumers, as their spending typically lags, we do not expect much spending from the tax cuts until late in 1987. Thus, the bottom line on macroeconomic effects over time: the tax bill is a negative for the economy next year and a positive in 1988 and 1989.

For the trade sector, it is hard to see anything in the bill that helps with our large deficit. In fact, it ought to make the deficit worse. Of the monies that go to consumers, about 10% leaks abroad. A few years ago the leakage was estimated at 4%-5%. The bill will not help U.S. business compete better in international markets.

As for the financial markets -- the fixed income and stock markets, we would expect interest rates to go down based solely on the tax bill. Because of lower marginal rates, the after-tax return on savings rises and the after-tax cost of borrowing rises. Theoretically, monies should flow into savings and away from borrowing, allowing nominal interest rates to decline slowly. If all things were equal, the bill would be a push towards lower interest rates. However, there are a host of other factors that determine interest rates -- inflation, growth, the Federal Reserve, how the dollar behaves, etc.

For the equity markets, the impact is mixed. The best deal around in an investment sense is ordinary income. Nevertheless, the income effect will make much more monies available for investment in stocks and bonds. The offset is that investor preference will be for high income, high dividend yielding securities. Given the change in the capital gains treatment, it will be more preferable for people to go into safe, sure returns rather than high beta stocks.

On a fundamental basis over 5 to 10 years, the value of the stock market should not be hurt by this bill. In the near term, the bill is a definite negative for the stock market because of: 1. the taking of capital gains between now and the end of the year; 2. the added recession risk to the economy in the first half of next year; and 3. general uncertainty over the total effect of the bill.

In addition to the reverse trickle down theory, there are two other ways the bill is supposed to work. One, there should

be an outpouring of supply-side work effort. Two, hidden revenues, such as in the underground economy, surface. Thus, there will be less need to raise taxes in the future to solve the deficit problem. However, the system will offset these trends by working through innovation in the allowable tax avoidance methods.

In summary, the tax bill is another big experiment of the Administration. Somehow their moves always seem to work out right. So, I am upbeat about the tax change.

Implications for the Securities Industry & Its Customers

Herman M. Schneider
Coopers & Lybrand

In 1987, there will be a 38 1/2% top rate for individuals and a 28% capital gains rate. In 1988, while there is a 28% top individual rate, there is a middle income bracket ($71,900-$149,250 joint) that is hit with a 33% rate. In 1987 and 1988, personal exemptions are going to $1,900-$1,950. However, it appears that if dependents are claimed because they are going to college, they lose their own exemption. In addition, at a certain upper income point, the personal exemption is phased out. It is in the income group, about $100,000-$200,000, that tax planning will become problematic.

The issue of whether or not to sell your stocks, given the increase in capital gains taxation, is very important. In most cases, it makes sense to sell stock now and buy it back. However, each individual's tax situation should be carefully analyzed and his investment expectations considered.

It is false that you are in the alternative minimum tax (AMT) because of capital gains. If you live in certain states with a 20% capital gains tax, the AMT of 20% makes the tax neutral. However, if you live in New York City, investors are subject to the AMT because of the State tax burden on the gain. If you are subject to the AMT in 1986 because of other tax preferences, it may not pay to take capital gain in 1986 and create an additional State tax burden which will not be deductible.

My class in tax law came to the conclusion that 60% of the Internal Revenue Code would disappear if they did away with the capital gains tax. Take note: the Conference Committee Report states that the entire capital gains structure is being kept specifically in order to allow for rate increases. I predict rates will go up and by 1990, the top rate will be 40%. On the other side of the coin, losses are deductible only to the extent of $3,000. However, now you get one for one, instead of one for two.

In terms of itemized deductions, there is a 2% "flaw." Unreimbursed business expenses and the cost of preparing tax returns fall into miscellaneous deductions. For brokerage firms that charge investment advisory fees, the question becomes should they switch to a commission basis so that the commissions are deductible.

Focusing on a very important aspect of consumer interest, IRS examinations can be a problem. What should be done about client issues which are being challenged now, such as silver and gold straddles. Do you pay the interest now? If the interest is paid in 1986, it can be deducted at assume the 50% bracket if the AMT is not involved. In 1987, 65% will be deductible at a 38% bracket and the allowable portion gets lower the following year. Should you file the return and follow with a claim for a refund? There is good reason to consider settling with the IRS sooner rather than later.

Investment income and investment expense. In general, the income of an individual is broken into three parts: active, portfolio, and passive. There are definitional problems with both portfolio and passive income. It appears that the nature of income, i.e., dividends, interest, capital gains, is irrelevant. The source of the income -- what creates the income -- is more important.

As for tax planning, the basic concept is to defer income, except for long-term gain. The traditional ways of deferring recognition of gains are still available. Prepay your State tax unless you're in the AMT and prepay your real estate tax. Accelerate charitable contributions over the next several years to this year. Lastly, large purchases with big sales tax tickets should be made in 1986.

CURVE BALL...PRODUCT & MARKET CHALLENGES

Corporate Finance: Instruments of the Future

Steven D. Oppenheim
Oppenheim, Appel, Dixon & Co.

Here is what I believe will be the major changes in the types of entities that are in the public market. There will be increased options and futures, with more and more hedging opportunities accompanied by a like amount of problems. Also, foreign currency gains attributable to transactions will be taxed as ordinary income. Thus, a situation is possible where there is ordinary income on the currency component and capital loss from the overall economic result of a transaction. With capital loss only deductible to $3,000 against gains, this impact will change the game for foreign currency transactions.

Because rates are going down, many people will decide not to take on capital risk for the same kind of after-tax return

offered by debt instruments with a greater degree of protection. Hence, a great many forms of debt instruments will be coming into the marketplace -- variable rate notes, participating notes, and the return of convertible bonds. Less risk to the investor, current deduction for corporations, current income to recipients -- these factors will fuel convertible issues. Moreover, there will be some interesting new features, like a variable conversion factor. In terms of accounting impact, corporations will be substituting the EPS question for the dilution problem, making for an interesting interplay of accounting and tax rules.

Even though there is an AMT problem for corporations, there will be an increase in the dividend paying securities that mirror money market instruments. These instruments will to some degree replace the basket trading strategies because they are easier to understand and more certain in effect. Remember, the tax bill has increased the concept of what is available to hedge.

With the increased difficulty of deducting interest expense, there will be less people playing the equity market on margin. More people will turn to debt instruments generating current income to offset margin interest expense, thus increasing the value of these instruments.

Finally, in response to the tax bill, the securities industry will come up with some of the most clever product and investment ideas seen in a couple of years. Those that are first with these new specific programs and tailored instruments will have an edge. However, intense competition has greatly shortened the period of benefit from innovation for the industry. It used to be 1-2 years, now it's only a couple of months.

Municipal Market

Joel R. Mesznik
Drexel Burnham Lambert Incorporated

Many of the issues concerning how the tax bill will affect the municipal market are unclear. However, the impact is severe in the long run. The PSA applied the regulations of the new tax bill as they are now understood to the municipal bonds issued in 1984. Of these issues, 41% could no longer be tax exempt. The municipal business is going to go down 40% according to these statistics, but ingenuity will mitigate some of that drop to 20% to 30% on the strictly municipal side of the business.

The long-term new issue market was about $200 billion in 1985. Many of these issues were "private purpose" bonds, where much of the proceeds are used by private parties. All those bonds will be either eliminated or greatly restricted under the Act.

Looking to 1988 -- 1987 is too uncertain to estimate yet, we expect about $100 billion in tax exempts. The reason for the severe drop is not just the tax bill. Much of 1985's volume was refundings, predicated on low interest rates. We don't expect to see that in the near future. The remaining portion of municipals, about $20-$30 billion, will be taxable bonds structured very much like corporate bonds.

The municipal market in 1988 will resemble the market of 1983, with very strong demand from retail investors and unit investment trusts. Retail will probably be about 50% to 70% of the total market. The new effective tax rates are not going to be very different for the typical municipal buyer than they were in the past. Banks will be as significant a buyer as they were in 1983 and some insurance companies will also be buyers.

As for municipal bond insurance, of the $200 billion of municipal bonds issued in 1985, about $47 billion or 25% was insured by the four large insurance companies in this business. If our volume drops in half, their premium is cut in half. In addition, the perception of risk that has made insurers such significant players in the municipal market has dropped. The need to have a triple-A rating has subsequently lessened. Moreover, the spread between a triple-A and a single-A municipal has declined from about 50 to 70 basis points two years ago to half of that right now.

Given a 250% discrepancy in insurers' high and low bids for a recent issue, it's obvious that they are having a problem identifying what their future market and business will be. There are two options. One, they can lower their premiums or two, they can change their business altogether and become more than just a municipal insurer.

In the last 90 days, we have seen about $2 billion of taxable municipal bonds come to market. These have generally been triple-As, structured comparably to corporate bonds. That means a one-term maturity, in contrast to the serial issues of the municipal market. Municipal issuers will have to adjust to that. The municipal market in an average year may see three or four thousand issues, and each issue has serial bonds.

The taxable market will not be receptive to small issues. National markets will probably not accept issues of under $100 million without penalty. Consequently, what may emerge is an attempt by small issuers to pool together to enter the national capital markets. Pools will probably be made up of similarly rated issues; blind pools where the money is raised first and then allocated to different issuers. In addition, there may be a warehousing mechanism by which investment banking firms or banks will purchase small issues, put them into one pool, and then sell a major pool.

So far, the buyers of taxable municipals have been the buyers of traditional corporate bonds, 50%-70% pension funds

and corporations and the remaining 30% foreign investors. Interestingly, all taxable municipals done so far have been under state names. Foreign buyers prefer to buy what they perceive to be sovereign credits and this has stirred great interest abroad. Retail investors will be attracted to the taxable municipal market because of attractive spreads. Right now, triple-A taxable municipals are about 135 basis points over the 10-year Treasury.

It will be interesting to see how firms handle the distribution of taxable municipals. Should they be done through the municipal desk and municipal sales force? Should the corporate desk price the issue and then turn it over to the municipal sales force? Different firms will use different approaches. All in all, there will be a lot to learn in the municipal market over the next two years.

Limited Partnerships & Direct Investments

Stephen J. Treadway
Smith Barney, Harris Upham & Co. Incorporated

The limited partnership and direct investment industry was not headed for good times prior to this tax bill. The 1984 tax bill killed some of the abusive aspects of our business and limited other legitimate aspects. At the same time, oil and gas, the major mainstay of the limited partnership business, did not perform. Hence, the industry in the last year and a half had backed itself into real estate as its primary means of support. However, we began to witness, and the press began to report about, a lot of overbuilding in real estate.

The 1986 tax bill has done for our industry what we could not do for ourselves -- it has changed the very nature of our business. There are two key overall effects. First, the value of excess tax losses in a partnership over the amount of cash that it actually distributes has been lost. Second, yield or cash has been made king. The business has gone from one of selling projections where cash flow begins in the future to one that will require an immediate cash yield if the deal is to be done. Our basic asset categories remain the same, only the pricing is affected by the bill. Real estate assets will have to drop in price. Deals that were done on a tax-driven basis will have to be resold on a cash-driven basis.

The two immediate effects of the bill in the long run mean that, without further legislative change, the limited partnership business will resume its growth and gain respectability. Respectability is important. In 1985, limited partnerships, excluding MLPs, raised $15 billion of new equity. In contrast, the IPO market raised half that amount.

For many years, our industry has tried to get tabular representation or coverage in the Wall Street Journal. We will get that coverage in the future. Why? In one stroke, our business has become based on yield, is more simple and will be part of the fixed income market. Limited partnerships used to be sold in part on the quality of the tax opinion. No more tax opinion discussion; just yield and growth. The complicated structures of these partnerships will become for the most part a thing of the past. We will grow into the huge fixed income market.

There is one benefit -- a tax rate differential. A small corporation paying taxes at 34% may wish to change to a partnership paying 28%. Also, it would be advantageous for a leveraged buyout to use a partnership format, buy the assets and pay a lower tax rate. Almost every aspect of this business should grow. Our firm is doing more business this year than last in traditional areas because we switched to yield-oriented transactions.

The future looks bright. Caution, however, should be used in the "transitional deal," where an asset was bought or contracted for prior to passage of the bill and priced under the old bill but which will disguise itself as a yield deal in the new environment. The key to our new opportunities will be whether or not Congress delivers on the lower bracket for partnerships versus corporations and whether or not they try to take away the MLP format. Even without the MLP format, the traditional limited partnership business should grow for all the reasons described.

PLAYING TO THE FANS...RETAIL CUSTOMER OPPORTUNITIES
(Panel Discussion)

Robert N. Gordon, Twenty-First Securities Corporation
(Discussion Leader)
Richard J. Capalbo, Drexel Burnham Lambert Incorporated
Edward Soule, Edward D. Jones & Co.

Has the Tax Act of 1986 altered the marketing strategy of your firm? We began altering our strategy a year or more ago as we saw the changes coming down the pike. (Soule) We change our marketing plan regularly. The last time our marketing strategy underwent a major change was with the Tax Act of 1981, which affected our marketing strategy more than the current tax bill. The 1986 bill will probably prove investor positive but not to the extent of the 1981 bill. From our point of view, marketing changes evolve with the amount of after-tax income investors get to keep. (Capalbo)

In general, have you seen a lot of inquiry from customers about the new law and how it might affect their investments? What has your firm been doing to take advantage of this? We've experienced an avalanche of customer concerns. Some investors have been fence-sitting in the past 6 months and others, who

structured their finances on the old tax law, are in shock over the radical change. We've been focusing more on bringing brokers up to speed and have not as yet been sending much material to clients. (Soule) At the point where we were confident that Congress was serious about tax reform, we started publishing a monthly newsletter, pointing out what looked likely to pass and what customers should start thinking about. In addition, we started a major seminar program and met with thousands of accountants and attorneys to deal with "third-party questions." (Capalbo)

Have you had much interest in the sell-buy back strategy to take advantage of this year's lower capital gains rate? Both firms are advocating caution with the use of this strategy. For some investors the sell-buy back strategy may make good sense. Other investors, however, should weigh their long-term investment objectives.

In 1988, there will be a zero holding period for all investments. Do you think that will change the investment strategy of the retail investor? The philosophy that the patient investor is rewarded will probably maintain its validity. We think that the long-term investor will still be the larger market. (Soule) Since the economics of short-term trading have been much improved, some people will reevaluate whether a short-term trading strategy makes sense. There will be some new players in that part of the trading spectrum, but the change will not have a major impact on the average investor. (Capalbo)

Given new severe restrictions, is your firm still going to market IRAs? We absolutely will. A lot of our customers are going to qualify under the income restrictions, and also many of our customers are not covered by qualified retirement funds. (Soule) The idea of a systematic savings plan is a good one, no matter how much money one makes. There are people that will continue to save $2,000 on a regular basis, even if they don't get the deduction. We will continue to market IRAs to these people, at least for a year. (Capalbo)

Do you think there will be more emphasis on products geared for retirement, such as deferred annuities? Our deferred annuity and single life premium business has surged in the last few months. Both of these products are being marketed as retirement savings plans and that business is primed to expand dramatically. (Soule) At this point, our position in life insurance products isn't very strong. It appears that certain life insurance products will take on increased value because there is simply no other product that will compete with them. We have commissioned a total reexamination of the types of insurance products we sell and we will be formulating a new marketing plan. (Capalbo)

Do you think there is still going to be interest in real estate and other tax-shelter type products? We believe there

will be continued interest in tax-advantaged products. We are reviewing everything we've sold to date, with an eye toward restructuring. The new bill creates a high regard for income through various types of techniques. There are plenty of opportunities. (Capalbo) For the past two years, the majority of our real estate has been economic-based investment. We see a continued interest in this business and are marketing strictly on a yield-cash basis. (Soule)

Do you think the new law will be a negative or a positive for firms in the real estate business? We believe our mortgage business will get a shot in the arm from the new law. We hope that many people, who in the past have borrowed on margin or on consumer-based terms, will now be looking to refinance their homes or to take out second mortgages. (Soule) That provision will be a big plus for the S&L's. We are far behind other firms already in the real estate business. Our lack of expertise in evaluating real estate would make it difficult to be competitive. Some mergers between mortgage-type companies and brokerage firms may result because of this change in the law. (Capalbo)

Do you agree that tax-exempt bonds are the only game left in town? Because of the Federal tax change, the state tax bill in certain states is going to become a much larger portion of the total tax picture. This will impact the investment patterns of people who live in these states. Much more so than in the past, different marketing strategies will be required for different states. Moreover, if the products can be made as attractive as munies, there is plenty of room left for real estate partnerships. (Capalbo) Our sales of munies have surpassed last year's level and we have increased our marketing efforts. (Soule)

The deductibility of margin interest will be changed somewhat under the new rules. Do you think it will have a major impact on margin accounts? We have positioned our margin business more as a loan business. In this respect, our competition is the local banks but our rates are lower. Initially, we could lose some margin business if for no other reason than the tax motivation is lost. (Soule) I think that margin activity will decrease a bit as people weigh the alternatives such as first or second mortgages. As for leverage via margin accounts, individuals may switch to other products in the futures or options markets. (Capalbo)

As a final note, what advice are you giving clients that call today? Take an inventory of where you stand in financial planning, where you want to be in the future and, considering the changes in tax law, plan how to get there.

THE HOME TEAM...SECURITIES INDUSTRY TAXATION

Presentation by
Randall K.C. Kau
Sullivan & Cromwell

The treatment of capital gains is the biggest item of impact on the securities industry not only for customers but for firms as well. It is not precise to say that capital gain is treated as ordinary income. The distinction between gains and ordinary income remains despite the absence of a differential. The most obvious point for firms and customers is that the allowability of capital losses remains the same, $3,000.

Another example where this distinction is important relates to Section 1256(e)(2) of the Code, which allows for a hedging exemption from application of the straddle rules. One of the most interesting and as yet unanswered questions is whether or not a reverse situation will now apply where people are trying to achieve ordinary income or loss treatment. While the distinction on the preferential rate is gone, it appears all of the lore and law about what is and is not a capital asset remains in effect.

A second major point to be made on capital gain is the effective date, which is written in terms of "taxable years beginning after 12/31/86" and has some specific applications for this industry. For installment sales of appreciated property, to the extent gain would be recognized in years after 12/31/86, that gain would be subject to higher tax rates. Also, for fiscal year partnerships which have recognized capital gain, that gain will not be included in the income of the individual partners until the calendar year in which the fiscal year ends. This also applies to distributions of capital gain dividends from regulated investment companies. There are many nuances in the new law with respect to capital gains.

Another major item for the securities industry is that by and large, the 1986 Act has not significantly amended the straddle provisions. Section 263 dealing with cash and carry transactions, 1092 and 1256, the mark-to-market rules, all remain in the law despite the absence of the differential for long-term capital gain.

There are a few small amendments that the securities industry should note. One, there is an extension or further limitation on the qualified covered call exception that was obtained in 1981 for a situation where a stock is sold at a loss and the option gain is recognized in a subsequent taxable year before the taxpayer has held the position for 30 days. Two, a positive point, the law treats fees received on the

lending of securities and substitute payments as entering into the 263 formula, thereby diminishing the amount of interest expense capitalized. Three, for pre-1981 straddles, those losses will be allowed if they were incurred in a trade or business, or if the loss incurred in a transaction entered into for profit though not a trade or business.

There are some major changes concerning dividends. The 85% dividends received deduction is reduced to 80% for dividends received or accrued after 12/31/86. For individuals, the $100/$200 dividend exclusion is repealed. In addition, there are some new rules for determining whether a dividend received by a corporate shareholder is an extraordinary dividend. First, the one-year holding period before sale has been increased to a two-year holding period before the dividend announcement date. Secondly, the basis of the stock may not be reduced below zero. However, any reduction which would reduce the basis below zero would be recaptured on sale.

The determination of whether a dividend is extraordinary will still be made under the current law's 10% (5% for preferred stock) of adjusted basis test. However, a taxpayer will also be able to elect to determine whether the dividend is extraordinary by reference to the fair market value of the stock rather than to the basis. The new rules are effective for dividends declared after July 18, 1986.

Regarding these dividends, the 1986 Act makes significant technical amendments, which include the following: 1. A taxpayer may use the fair market vlaue on day before ex-dividend date for dividends declared after date of enactment (October 22, 1986) to determine whether a distribution is extraordinary or not. 2. Except as provided in regulations, any redemption not pro rata to all shareholders or part of a partial liquidation are treated as extraordinary without regard to holding period. This is contained in a new Section, 1059(e), of the Code. 3. Qualified preferred dividends must also meet an extraordinary dividend test, based on whether the actual rate of return is greater or less than 15%.

Presentation by
Gerard A. Mangieri
Arthur Andersen & Co.

The new corporate alternative minimum tax (AMT) is no doubt the most far-reaching business tax provision in the new tax bill. The AMT is significant because it is, in effect, a second tax system that is parallel to, but separate from, the regular tax. The AMT broadens the corporate tax base and brings financial-accounting principles into the tax system by requiring that a portion of financial-statement income be included in the tax base. The message from Congress in

enacting the AMT is that all corporations with financial-statement income must pay some tax currently on that income.

Much of the AMT's significance lies in its rate. Whereas the prior add-on tax rate was 15%, the rate under the new alternative system is 20%. The relationship of the AMT to the regular corporate tax rate magnifies its importance. In 1988, the 20% AMT rate will be 59% of the 34% regular rate. The practical effect of this narrow spread between the AMT and the regular rate is that a relatively minimal amount of preferences or adjustments can trigger the AMT.

Under the new provisions, corporations that defer recognition of income for regular tax purposes must recognize the income sooner for the AMT. Of all the new provisions concerning the AMT, the general rule that one-half of book income in excess of alternative minimum taxable income (AMTI) be added to the AMT is most significant. This is not half of book income, but half of book income in excess of AMTI. Thus, the greater the disparity between book and tax accounting, the greater this adjustment. The book-income adjustment applies only in 1987, 1988 and 1989. After 1989, this income adjustment is replaced by the earnings and profits adjustment.

One particular item of note in calculating the AMT base: All tax-exempt interest attributable to private activity bonds issued after 8/7/86 is added to the AMT base as a preference. The new law, however, does provide a special rule for certain issues.

The new law introduces uniform capitalization rules. These rules will apply to assests held by a taxpayer in inventory or for sale to customers in the ordinary course of business. Thus, inventories of securities firms carried at cost will be subject to the capitalization rules. Certain costs will, therefore, be transferred from current deductions to inventory.

Historically, a taxpayer that sells an asset and receives some or all of the consideration in the form of a promise to pay in the future has been able to use the installment method to defer recognition of income and payment of tax from the sale until payments on the installment obligation are received. The new law prohibits the use of the installment method for certain specified types of transactions, one of them being publicly traded property. Hence, the use of the installment method is no longer permitted for sales of stocks or securities. The Finance Committee Report notes that for sales on an established securities market, in which cash settlement customarily occurs several days after the date on which a trade is made, gain or loss by either the cash- or accrual-method taxpayers must be recognized on the day the trade is executed. Therefore, this changes the long-standing rule that gains on the sale of stock or securities by individual taxpayers need not be recognized until the settlement date.

The securities industry, like all business, will have some adjusting to do in its spending on business meals and entertainment. The deduction for business meals and entertainment is limited to 80% of the amount that would otherwise have been allowable. In addition, the deduction for meals is now required to meet the same business-connection requirement that previously applied to entertainment expenses and lavish or extravagant expenditures are disallowed. In the way of entertainment, expenses for ticket purchases to the extent that they exceed the face value of the tickets are not allowable. As for skyboxes and other luxury seats at sports events, these are also disallowed to the extent the cost exceeds that of regular box seat tickets.

EXTRA INNING...RELATED ISSUES

New York State and City Issues

Simon Gold
Asiel & Co.

The State tax system largely conforms with the Federal system. By changing the Federal tax numbers with less in the way of deductions, the tax base will be broader for State purposes. The State is "terribly embarrassed" because it ends up with a windfall of about $2 billion. Even the City is a "little embarrassed" with several hundred million dollars of windfall. Of the State's $2 billion windfall, an estimated 94% is due to increased individual taxes.

What will happen to the windfall? While there is a general feeling the State will give back the windfall, there is the troublesome question of how the tax monies will be refunded. One State official has said: social policy may indicate that the windfall may not go back to those who paid it. At least half of the windfall comes from increased capital gains taxes. However, it seems it would be politically inexpedient as well as against social policy to give back money to those with capital gains because they are "rich".

Nevertheless, the increased revenues should be given back to those who have paid them. The Governor has asked a committee to devise a program to study the windfall, and SIA has formed an ad hoc committee to review what should be done. There is a simple way to fix the capital gains problem; i.e. continue to permit a 60% long-term capital gains deduction. In other areas, there may not be such simple solutions as almost every individual and corporation will be paying higher State taxes.

The City and State already have a tax problem without the windfall: a tax climate that motivates people to move out. Just bringing the situation back to the status quo is not the

answer. The State must come up with a program not only for directing the windfall but also to reform itself to some degree. However, the windfall will stymie consideration of State and local tax reform for awhile.

Although not yet final, the SIA has devised a broad based plan which calls for relief in capital gains taxation and reform of tax rates. Also included is a recommendation that the differential between unearned and earned income be eliminated. Next year, under the 4% differential, those people with unearned income will be paying 4% more than people with earned income. In the City tax area, the City still has the unincorporated business tax, even though this was dropped by the State several years ago. Perhaps the City will agree to drop this tax now. I hope that when all is said and done, a fair way of distributing the windfall will be found that encourages entrepreneurs and other highly motivated individuals to remain in New York.

Reporting & Compliance Issues

Thomas G. Vitez
Securities Industry Association

There are several items of note in the reporting and compliance area for the industry, three of them related to the new tax bill. The industry scored a victory in one provision of the tax bill -- the reporting of 1099 information. Firms will once again be allowed to furnish 1099 information on the annual statement, providing certain requirements are met. In terms of 1099 information, since taxpayers will have to start reporting tax-exempt municipal bond interest, firms will have to start providing this information to their customers as well.

Under the Senate bill, firms would have had major responsibilities in keeping track of deductible and non-deductible IRA accounts. However, the Conference bill places the responsibility primarily on the taxpayer. While firms will have to supply information regarding contributions and earnings, the taxpayer will have to calculate via a formula method the portion of each distribution which is a tax free return of capital compared to a return of dividend or interest.

Thirdly, a solution to the MLP compliance problem has been worked out. Firms will supply partnerships with the names of beneficial owners, thus avoiding the problem whereby the firm was responsible for taxes on MLP income for shares in Street name. A clearing center is being set up where firms will provide this information on a monthly basis. The clearing house will consolidate this information and supply it to the MLPs.

In terms of other items of interest, SIA testified that the original regulations on the withholding tax under FIRPTA were unnecessarily complex. We recommended that the withholding system should follow the traditional system of certification, W-8 or W-9, and that the broker should withhold the tax where holders are in Street name. Our recommendations will be incorporated in the regulations.

TIN penalty program issues are still under discussion. Our position is that government mismatches should be solved by government. If there are bona fide remaining problems, then the industry should offer assistance. The IRS is setting up a task force of staff and industry representatives to discuss problems with this program.

Another issue which is still "on the table" is the new reporting of OID on CDs. The IRS wants brokers to report OID not only on CDs they sold to a customer originally but also on CDs purchased in the secondary market or transferred in from another broker. We have recommended that the CD issuer be subject to Form 8281 filing requirements, thus supplying OID information for inclusion in IRS' 1212 publication. If these CDs are incorporated in the 1212 publication, we will be able to comply with the new regulations. We are awaiting further word from the IRS on our recommendation.

Summaries prepared by:
Carolyn Hildebrandt
Assistant Vice President

VOLUME

	SEPT 1986	JAN - SEPT 1986	SEPT 1985	JAN - SEPT 1985	% CHAN. J-S 1986-1985
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	150.8	140.7	97.9	104.8	33.8%
AMEX (MILS.)*	10.8	12.2	7.9	8.0	52.8%
NASDAQ (MILS.)*	104.9	116.0	74.4	77.6	44.4%
REGIONAL EXCHANGE (MILS.)*	27.4	23.1	16.8	18.2	27.0%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$124,644	$1,023,761	$66,237	$691,539	48.0%
AMEX (MILS.)	2,191	32,600	1,591	18,523	76.0%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	8,304	81,475	4,711	59,330	37.3%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	16,716	161,118	11,694	135,779	18.7%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	47.9%	49.3%	53.3%	51.8%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	17,758	140,501	11,531	103,638	35.6%
AMEX OPTIONS	3,940	37,181	2,308	24,454	52.0%
COMMODITY	17,124	142,364	12,759	117,966	20.7%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

YIELDS

(MONTHLY AVERAGES)

	OCTOBER 1986	OCTOBER 1985	BASIS POINT CHG 1986-1985
BOND BUYER INDEX (20 BOND)	7.08%	9.00%	(200)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	8.86	11.02	(216)
Baa CORPORATE	10.24	12.36	(212)
RATIO Aaa CORPS. TO Baa CORPS.	0.87	0.89	(3)
MUNICIPAL BOND YIELDS (MOODY'S)	7.08	9.08	(200)

PRICES

(END OF MONTH)

	OCTOBER 1986	OCTOBER 1985	% CHAN. Y-T-D 1986-1985
DOW JONES INDUSTRIALS	1877.81	1390.25	35.07%
STANDARD & POOR'S 500	243.98	189.82	28.53%
NYSE COMPOSITE	140.42	109.65	28.06%
AMEX MARKET VALUE INDEX	265.59	228.61	16.18%
VALUE LINE COMPOSITE	230.44	195.04	18.15%
NASDAQ COMPOSITE	360.77	292.54	23.32%

UNDERWRITING

	OCTOBER 1986	OCTOBER 1985	% Change 1986-1985
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$30,079.0	$11,606.4	159.2%
Common Stock	$4,285.3	$2,026.0	111.5%
# of Common Stock Issues	114	70	62.9%
Preferred Stock	$974.5	$494.8	96.9%
# of Preferred Stock Issues	14	9	55.6%
Corporate Debt	$24,819.1	$9,085.6	173.2%
# of Corporate Debt Issues	153	91	68.1%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$7,427.1	$17,341.3	-57.2%
# of Issues	153	429	-64.3%
Competitive	$1,653.2	$4,491.2	-63.2%
# of Issues	53	143	-62.9%

Source: IDD Information Services

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Management & Professional Earnings in the Securities Industry	Annual SIA survey which provides base salary and bonus information on 128 middle management and professional positions. The study is based on input of 63 SIA-member firms employing 117,000 individuals, thus representing almost 50% of total employment at SIA-member firms. Data presented include: year-end 1985 vs. year-end 1984 comparisons of salaries and bonuses, nationally and in NYC.	SIA Survey Department SIA member - $400 Others - $1,200
"Next Year's Tax Bill: Fix Capital Gains"	Author argues that the repeal of the long-term capital gain preference at the Federal level will probably be adopted at the state level as well. Thus, much higher rates on capital gains undoubtedly will cause many taxpayers to refrain from realizing gains. Immobility of capital will have a serious impact on the venture capital market. If these changes were done in the name of producing revenues and income redistributions, legislators are in for a rude awakening. Author urges restoration of the preference for capital gains and, at the very least, indexation of gains.	Tax Notes 10/27/86
"Nomura Securities Global Ambitions"	Although Nomura is the world's largest securities firm with 4 million retail customers and a capital base of $3.17 billion, it lags behind its competitors in international investment banking. Article reviews problems Nomura faces in climbing to the top position in international investment banking and the firm's plans to overcome this.	Dun's Business Month November 1986

"Diminishing Returns"	Brokerage firms are changing their compensation schedules regularly. Most have revised them downward over the last several years. The continual changes are putting a new kind of pressure on brokers and some see the changes as part of a move toward salaried brokers. Article reviews payout changes at various firms.	Registered Representative October 1986
"The Americanization of British Pensions"	A host of U.S. investment trends and techniques are transforming the management of U.K. funds. Article examines the two latest imports from America: indexing and the "beauty contest." While an estimated 25% of the U.K. equity market is indexed compared with 10% in the U.S., the massive British Railways pension fund is conducting an elaborate talent hunt for outside managers.	Institutional Investor International Edition October 1986
"Do Plan Sponsors Really Need An Investment Manager?"	Article examines the degree of market efficiency (modern portfolio theory), then discusses the pros and cons of passive versus active money management. Concludes with a list of investor types who are better off using indexing as a portfolio management approach.	Investment Decisions October 1986
"Recent Developments in Corporate Finance"	Reviews the recent trends in balance sheets of nonfinancial corporations, considers the contributions of new markets and products to these trends, and assesses the implications of these markets and products for the future. Concludes: With the increased R&D of new financial instruments plus deregulation in foreign financial centers, the pace of financial innovation is unlikely to slacken.	Federal Reserve Bulletin November 1986
"How Did your Mutual Fund Do?"	Quarterly ranking of mutual fund performance based on Lipper Gauge. Extensive coverage of third quarter results, including sector funds, top three managers over time, and foreign-bond funds.	Barron's 11/10/86